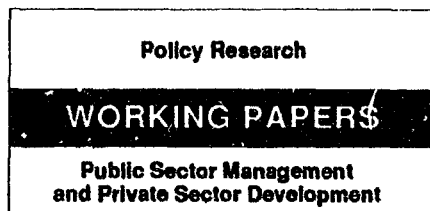


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# **Public Institutions and Private Transactions**

## **The Legal and Regulatory Environment for Business Transactions in Brazil and Chile**

**Andrew Stone  
Brian Levy  
and  
Ricardo Paredes**

Chile enjoys a better formal legal and regulatory environment than Brazil. But differences are reduced by Brazil's effective informal substitutes. In fact, Brazilian entrepreneurs rank macroeconomic and political stability as a higher priority than legal and regulatory reform.

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This paper — a product of the Public Sector Management and Private Sector Development Division, Country Economics Department — is part of a larger effort in the department to promote realistic assessment of obstacles to private sector development through firm-level surveys. Copies of the paper are available free from the World Bank, 1818 H Street NW, Washington, DC 20433. Please contact Gloria Orraca-Tetteh, room N9-069, extension 37646 (April 1992, 30 pages).

Drawing on the new institutional economics, Stone, Levy, and Paredes examine the impact on businesses of Brazil's relatively complex, nontransparent legal and regulatory institutions and compare their costs with those of Chile's institutions, which are relatively simple.

They examine four basic areas where legal and regulatory institutions could create critical obstacles to efficiency in the garment industries of Sao Paulo and Santiago:

- The start-up of a new business (entry).
- The regulation of business.
- Orders by customers of garment firms.
- Sales with credit.

They find that Chilean business transactions benefit from legal simplicity and more consistent enforcement than in Brazil, but that these perceived advantages are offset because of the differences between formal law and practice in Brazil. In two of these areas, Brazil has evolved some effective institutional substitutes to reduce

the costs that would otherwise have been imposed by inefficient formal institutions.

In the entry of new businesses, professions have evolved to transform the process of registering a new business from a potentially torturous obstacle path into a fairly affordable one-stop process. In debt collection, information systems limit the need to resort to the formal legal system.

Nonetheless, regulation — in the form of complex and resource-intensive tax rules, regulatory processes, and conflict-resolution mechanisms — raises the cost of transactions for Brazilian businesses. Costs are further raised by greater uncertainty and frequent renegotiation of orders. So, overall, the environment for business in Brazil is less favorable than that in Chile.

But the authors warn against a preoccupation with formal legal and regulatory reform as a short-term means of promoting economic development. In the eyes of Brazilian entrepreneurs, macroeconomic and political instability are far more important problems.

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**Public Institutions and Private Transactions:  
The Legal and Regulatory Environment  
for Business Transactions in Brazil and Chile**

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**Public Institutions and Private Transactions:**  
**A Comparative Analysis of the Legal and Regulatory Environment**  
**for Business Transactions in Brazil and Chile**

Andrew Stone, World Bank  
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**ABSTRACT** This paper draws on the new institutional economics to examine the impact on businesses of Brazil's relatively complex and non-transparent legal and regulatory institutions and compares their costs to those of the relatively simple institutions in Chile. It examines four basic areas where legal and regulatory institutions could create critical obstacles to efficiency in the garment industries of Sao Paulo and Santiago: the start up of a new business (entry); the regulation of business; orders by customers of garment firms; and sales with credit. The results show that Chilean business transactions indeed benefit from legal simplicity and consistency of enforcement relative to their Brazilian counterparts, but these benefits are mitigated by the differences between formal law and the law in practice in Brazil. In two of the four areas examined, Brazil has evolved some effective institutional substitutes to reduce the costs that would otherwise have been imposed by inefficient formal institutions. In the entry of new businesses, professions have evolved to transform the process of registering a business from a potentially tortuous obstacle trail into a fairly affordable one stop process. In debt collection, information systems limit resort to the formal legal system. In the remaining two areas, the existence of substitutes does not bring transactions costs down to the level of Chile. Brazilian businesses confront high transactions costs in regulation, through more complex and resource intensive regulatory processes and conflict resolution mechanisms. In orders, greater uncertainty and frequent renegotiation raise costs. Overall, the environment for business in Brazil is inferior to that in Chile. Yet, even with these costs, the findings warn against a preoccupation with formal legal and regulatory reform as an immediate means to promote economic development; in the eyes of Brazilian entrepreneurs, problems relating to legal and regulatory institutions take a distinct back seat to macroeconomic and political instability.

## 1. INTRODUCTION

How do complex, nontransparent laws and regulations, and a somewhat inaccessible, expensive and slow set of formal legal conflict resolution mechanisms affect business transactions? This study uses the approach of the new institutional economics (NIE) to contrast the impact of the complex legal and regulatory environment in Brazil with that in Chile, where regulatory and legal reforms have sought to facilitate market efficiency. Additionally, the study examines the importance of legal and regulatory obstacles to the growth and operation of Brazilian businesses relative to other constraints. The results illustrate a central point: institutions matter economically in the actual costs (and benefits) they create for businesses, not in their compliance with ideal forms.

The study examines four basic areas where legal and regulatory institutions could create critical obstacles to efficiency:

- \* the start up of a new businesses (entry);
- \* the regulation of business:
- \* orders by customers; and
- \* sales with credit.

The first two areas involve transactions between a business and the government, while the second two involve transactions between businesses. Interviews with garment firms were used to learn in as quantitative a way as possible the costs and problems associated with particular transactions.

The results show that Chilean business transactions indeed benefit from legal simplicity and consistency of enforcement relative to their Brazilian counterparts, but these benefits are mitigated by the differences between formal law and the law in practice in Brazil. In two of the four areas examined, Brazil has evolved some effective institutional substitutes to reduce the costs that would otherwise have been imposed by inefficient formal institutions. In the entry of new businesses, professions have evolved to transform the process of registering a business from a potentially tortuous obstacle trail into a fairly affordable one stop process. In debt collection, information systems obviate the need for use of the formal legal system in the vast majority of cases. In the remaining two areas, the existence of substitutes does not bring transactions costs down to the level of Chile. Brazilian businesses confront high transactions costs in regulation, through more complex and resource intensive regulatory processes and conflict resolution; and in order through greater uncertainty and frequent renegotiation. The net combination of these effects implies a somewhat inferior environment for business in Brazil.

Yet, even with these costs, our findings warn against a preoccupation with formal legal and regulatory reform as an immediate means to promote economic development. The relative ranking of obstacles to growth perceived by Brazilian entrepreneurs makes clear that problems relating to legal and regulatory institutions take a distinct back seat to macroeconomic instability, and that Federal government economic policy imposes greater insecurity on property rights than any regulatory or judicial institutional weakness. Once uncertainty of policy and prices has been addressed, an agenda of labor

and tax regulatory simplification predominates. Only then do the obstacles imposed by defects directly tied to the formal legal system emerge as binding constraints on businesses.

## 2. SOME METHODOLOGICAL ISSUES

This section summarizes some of the theoretical controversies that motivated the research, clarifies the reasons why Brazil and Chile were selected as targets of study, and outlines how the field surveys were organized.

Formalistic versus New Institutional Approaches Ideally, a market economy develops institutions (including markets, contracts, firms of various characteristics, and systems of regulation) that allow the highest value to be attained from its resources.<sup>2</sup> Traditionally, neoclassical economics has assumed such institutions to be in place, and consequently that transactions between buyers and sellers are costless, instantaneous and based on perfect information.<sup>3</sup> Two distinct, but related, literatures increasingly have begun to explore deviations from this ideal.

The field of "Law and Development" holds that rapid market-based economic growth depends on: a system of simple, transparent laws and regulations; consistent interpretation and enforcement (like cases are treated alike); just and rapid resolution of conflicts (justice deferred is justice denied); and a social attitude of respect for legal and regulatory institutions.<sup>4</sup> The common law systems of England and the United States, as well as the civil legal systems of Western European countries are taken as ideals.<sup>5</sup> Deviations from the ideal obstruct development. The best known recent example is the discussion in Hernando de Soto's The Other Path of the costs of starting a business in Lima, Peru. De Soto finds complex, strangling Peruvian law and regulation to be a powerful disincentive to formality, hence a stimulus for the rise of a large informal sector unprotected by formal law.<sup>6</sup> De Soto's work stands out in its careful observation of the many effects of the legal and regulatory system on the poor and its attempt to document the costs of doing things "by the book".<sup>7</sup> The Law and Development literature is prescriptive in its conclusions: societies that are not ruled by transparent laws and consistent enforcement should be.

The New Institutional Economics (NIE) has also observed the divergence of law and regulation from an ideal: that of the neoclassical economic model. NIE began with an emphasis on the proper

definition and enforcement of property rights,<sup>8</sup> but has evolved to look at the impact of institutions on the cost of transactions. According to Williamson [1990], transactions cost economics recognizes that the definition, comprehension, and enforcement by courts of property rights are all problematic. Therefore, non-market social institutions arise to provide "contractual integrity for transactions." Transactions costs economics, unlike the Law and Development literature, recognizes that formal law and courts do not and cannot, alone, resolve contractual problems relating to transactions:

Transaction cost economics is specifically concerned with the governance of contractual relations (by markets, hierarchies, and by hybrid modes) and rejects the proposition that the courts can administer justice in an informed, low cost, and efficacious way. Rather than place the principal burden of contract enforcement on the courts, it argues instead that court ordering operates in the background role and that private ordering by the parties is the principal contractual arena. Thus...transaction cost economics focuses expressly on the comparative efficacy with which alternative governance structures manage transactions during contract execution.<sup>9</sup>

Transaction cost economics enriches the view of institutions by weighing the costs and benefits of alternative corporate governance structures and other institutions.<sup>10</sup> Thus while NIE and Law and Development bear some family resemblance, NIE judges institutional arrangements based on their empirical impact on the efficiency of economic transactions, not on their resemblance to rational Western norms of law and jurisprudence. Efficiency is achieved, not only through low cost exchanges, but through the ability of businesses to commit assets to a series of transactions with another business; a dimension known as asset specificity. Central to efficiency is the low-cost availability of information needed to evaluate products being exchanged and to police and enforce agreements.<sup>11</sup> A central strength of the work of such writers as Douglass North is the recognition that informal institutions (besides laws and formal organizations) may play as important a role in determining the costs of doing business as formal ones.

The field of NIE is relatively new, and has only recently begun grappling with the difficult task of measuring transactions costs.<sup>12</sup> This study contributes to the growing literature devoted to the measurement of these costs by presenting several indicators of the costs involved in our four transaction areas. These indicators allow both comparisons between countries and between firms of different sizes. The information is used to evaluate the relative strengths of Law and Development and NIE. If bad practice (hence costly transactions) always accompanies bad law, the formalism of the Law and Development approach will prove sufficient. If, however, there are efficient transactions in the absence

of good law, then an empirical approach of measuring the benefits and costs of institutional arrangements would seem justified.

The legal and regulatory environments of Brazil and Chile. Our study was set in two countries of fundamentally different policy and institutional environments: one that is highly interventionist in an exceptionally detailed way, and another that has engaged in systematic reform to reduce the size and role of government in markets and to impersonalize the rules of economic competition. Brazil's government has traditionally been heavily involved in the economy, both through direct ownership of public enterprise and through exquisitely detailed regulation, subsidy and taxation of the private sector.<sup>13</sup> Rosenn [1984] describes a system in which laws are so complex and court procedures so expensive that formal institutions could not be relied on for dealing with day to day problems in regulation and business transactions.<sup>14</sup> He describes Brazil as a dualistic system, having simultaneously a rigid formal law and, quite separately, a "practical system for ordering affairs." Formal law is extraordinarily specific and is approved without reference to its consistency with existing law. Thus a number of inconsistent laws may apply to an otherwise simple business transaction, such as the "1,470 separate legal actions with thirteen government ministries and fifty agencies" required for an export license in 1981.<sup>15</sup> He describes the use of the *jeito* [the fix] as a means of achieving a degree of simplicity, common sense and speed (for both licit and illicit purposes) in a system that is tangled, illogical and slow. The *jeito* is a way around the formal law, either in the form of an evasion by a private citizen or a sensible accommodation achieved with the help of a properly motivated government official. The *despachante*, a professional go between, facilitates the latter form of *jeito*, enabling business to proceed somewhat logically in a formal environment hostile to efficiency.<sup>16</sup> While Rosenn decries the erosion of the power and efficiency of law, he ultimately sees advantages to the informal institutions that have evolved. He suggests that these institutions, while more costly than a more rational formal legal system, allow business to process with "stability and predictability."<sup>17</sup> Yet, true to the Law and Development approach, he ultimately insists that the developmental benefits of legal reform towards a system with efficient laws, "a high degree of obedience to the rule of law, and impersonal, efficient administration of the laws" justify dramatic change.<sup>18</sup> While we fully sympathized with Rosenn's call for reform, we felt his claims about the relative costs and benefits of Brazil's system merited empirical scrutiny.



Given the complexity of Brazil's formal law and legal and regulatory processes, we envisioned several possible states of Brazilian society. The first possibility, raised by a literature discussing elite power and oligopoly in Brazil, is that institutional failures have created fixed entry and other costs that offer advantages to size and reputation. In this scenario, relationships of trust bridge gaps in legal institutions, binding profitable, larger "insider" public and private institutions together, while limiting the entry and growth of "outsiders" who lack access to such privileged relationships.<sup>19</sup> A second scenario, suggested by Rosenn's writing, is that all businesses operate under the handicap of an inefficient system that slows development and puts Brazilian industry at a competitive disadvantage with nations having efficient legal and regulatory systems.<sup>20</sup> Finally, all firms may have found adequate institutional substitutes that allow them to operate about as efficiently as comparable firms in countries with better functioning formal institutions. In this case, the major question would center around the dynamic effect of reliance on informal mechanisms (issues raised by North), rather than its consequences for static efficiency.

Only a comparison with some other country would allow a clear differentiation between a scenario of generalized inefficiency from formal institutional failure and one of efficiency through effective substitutes. To this end, Chile was chosen as a country where years of conscious reform aimed at improving market efficiency began from a base of a complex legal and regulatory environment comparable to Brazil's. Besides comprehensive macroeconomic reform, Chile has moved to deregulate the economy, attempting to rationalize price, tax and labor regulation and deregulating and privatizing the financial sector.<sup>21</sup> It is now regarded as having a relatively well-defined property rights system and a liberal economy. In dramatic contrast to the image of Brazil, where influence and contacts with bureaucrats have been portrayed as vital to economic success,<sup>22</sup> a recent study finds an environment where entrepreneurs rank "politician and authority contacts" as the least important of seven factors determining their success.<sup>23</sup>

The field surveys. The parallel studies of Brazil and Chile center on the garment industry in the cities of Sao Paulo and Santiago (and environs). The garment sector was chosen for two reasons. First, unlike many other industrial sectors in Brazil, it was not being specially promoted by the government. A recent evaluation showed the clothing and shoe industry to be low in regulatory and promotional

constraints on capital mobility and competition, as well as low in the level of fiscal, credit and procurement related incentives relative to all other industrial sectors.<sup>24</sup> Thus, sector-specific interventions were less likely to cloud the impact of economy-wide law and regulation on businesses. Second, the clothing industry has no large, inherent scale economies (hence has small, medium and large firms competing), enabling the study of problems faced by firms of a variety of sizes. Note, however, that transactions in the garment sector tend to be short-term, limiting our ability to extrapolate from our findings to the impact of the legal system on long-term transactions.

Interviews were conducted with 42 garment firms in each country. The sample was stratified by size of firm. The Brazilian sample comprised 5 large firms (over 500 employees), 13 medium firms (101 to 500 employees), and 25 small firms (of 100 or fewer employees). Interviews were also conducted in Brazil with officials of three textile firms, with three garment subcontractors (not included in the sample), as well as with lawyers, bankers, despachantes and leaders of industry associations. The Chile sample comprised 7 large firms, 25 medium firms and 10 small firms.<sup>25</sup> The Chilean sample was stratified to attain ethnic representation proportionate to that in the population of garment industry entrepreneurs, as different groups supply different ends of the market. In both cases, relative to the population of firms, large and medium firms were oversampled. A printed questionnaire, highlighting experiences and obstacles in the four transaction areas discussed below, was verbally administered by one of the authors or their assistants directly to the proprietor or an officer of each firm.<sup>26</sup> The limited area of sampling and the relatively small sample size and the small numbers of firms in size categories responding to certain questions severely limits the ability to make valid statistical inferences from the data for the two nations under study, but the results here are highly suggestive of important areas for policy attention.

### 3. BUSINESS-GOVERNMENT TRANSACTIONS

Business-government transactions shape the costs of going into and staying in business, as well as the level and certainty of returns to investment. Dealings between business and government are inherently unequal because one party (the government) is making and enforcing the rules that affect the interests of both. Hence, lack of transparency in the regulation of entry and operation may invite

opportunistic behavior by officials enforcing the law. Lack of consistency in law and administration increases bureaucratic discretion and may increase opportunities for government officials to seek rents. Institutional failures may impose costs that restrict competition, distort patterns of investment or of sales and/or divert entrepreneurial attention from economically productive activities to seeking rents. Furthermore, these failings make it hard for businesses to predict the outcome of investment decisions. Yet, as the data will demonstrate, the impact of institutional failings (hence the value of reform) depends on the ability of businesses to find substitutes for inefficient formal institutions.

We examine first the impact of the procedures required to start-up a business on entry. Thereafter we explore the impact on firms of the tax and regulatory requirements associated with business operation. Taken together, the evidence on the transactions costs of entry and regulation offer a surprising insight on the nature of business informality.

Entry -- Access to Formality Entry is a critical point at which the competitiveness of an economy is determined. Barriers to entry, including large fixed costs, may protect those firms already in business at the expense of newer firms. If new entrants cannot afford to become formal, they may be doomed to stay small, needing to be invisible to authorities, hence denied access to capital and most associations with formal businesses. If even this route is foreclosed, large incumbent firms will dominate markets.

In 1983 a team from Hernando de Soto's Institute for Liberty and Democracy tried to set up a small garment firm on the outskirts of Lima. In a now famous experiment, they followed the formal, legal process and found that it took them 289 days to fulfill eleven requirements, \$194 in direct costs (including two bribes they had to pay, but not including eight they were asked to pay but avoided) and over \$1,000 in foregone profits. Opening a store was relatively simpler, but more expensive, involving three government departments, requiring 43 days, and costing \$590.56, or 15 minimum wages. This high "cost of access" was identified as a major contributor to the large number of informal enterprises in Peru. De Soto's team did not, however, examine the actual costs incurred by garment firms in accessing formal status, only the cost and delays of "going by the book." De Soto suggested that these costs were important explanations of the large number of small, informal firms in Lima.

Brazil, too, has about eleven steps required for "access to formality" in industry, and we asked businesses about the difficulties they encountered in becoming formal. Contrary to our expectations,

they had few complaints. Entry into garment manufacture turns out to be a relatively easy, one-and-a-half-month, one-stop process in practice, though not in law.

In practice, most firms enter with a single payment to an accountant or a despachante. On average, the numerous steps (e.g. with federal, state and local tax authorities, the Ministries of Industry and *Fazenda*, the commercial registry, the cadastral authorities, etc.) were completed by the accountant within 6 weeks.<sup>27</sup> The total cost of entry was not insignificant, with estimates varying from as low as \$150 to as high as \$2500, averaging around \$640. Yet several microenterprise or small limited liability corporations in our sample had been able to register for under \$500 in about a month,<sup>28</sup> suggesting that the one-time fixed cost of entry is not an overwhelming obstacle to formality. When specifically questioned on difficult steps of entry, most firms reported no problems. Accountants (and occasionally despachantes) have provided a simple, clear, effective substitute for the government's complex institutions of business entry.<sup>29</sup>

**TABLE 1: TIME AND COST OF REGISTRATION<sup>30</sup>**

	BRAZIL	CHILE
Total Cost of Registering (in U.S. \$)	\$640 (n=15)	\$739 (n=15)
Total Time to Register (in months)	1.6 (n=17)	2.0 (n=16)

While \$640 and seven weeks may seem high, the Santiago survey provides a surprising comparison: the average cost of registration for all firms was higher, and the average it time took time a bit longer. For small firms the cost was lower than Brazil's, at \$500, and the mean time required just over seven weeks. For medium-sized firms, the mean cost reportedly averaged over four times as much, and it took them over two months to register. Yet, the time it took them may be misleading: in Chile, firms may start operation before the entire registration process is complete.

Overall, the conclusion is that Brazil has neither an overwhelmingly costly nor an overwhelmingly difficult entry process. (In fact, the comparison raises questions about the efficiency of Chile's system.) Sao Paulo's formal legal requirements would have implied a much more difficult process than the procedure in practice. Only actual measurement reveals the moderate cost of registration in Brazil.

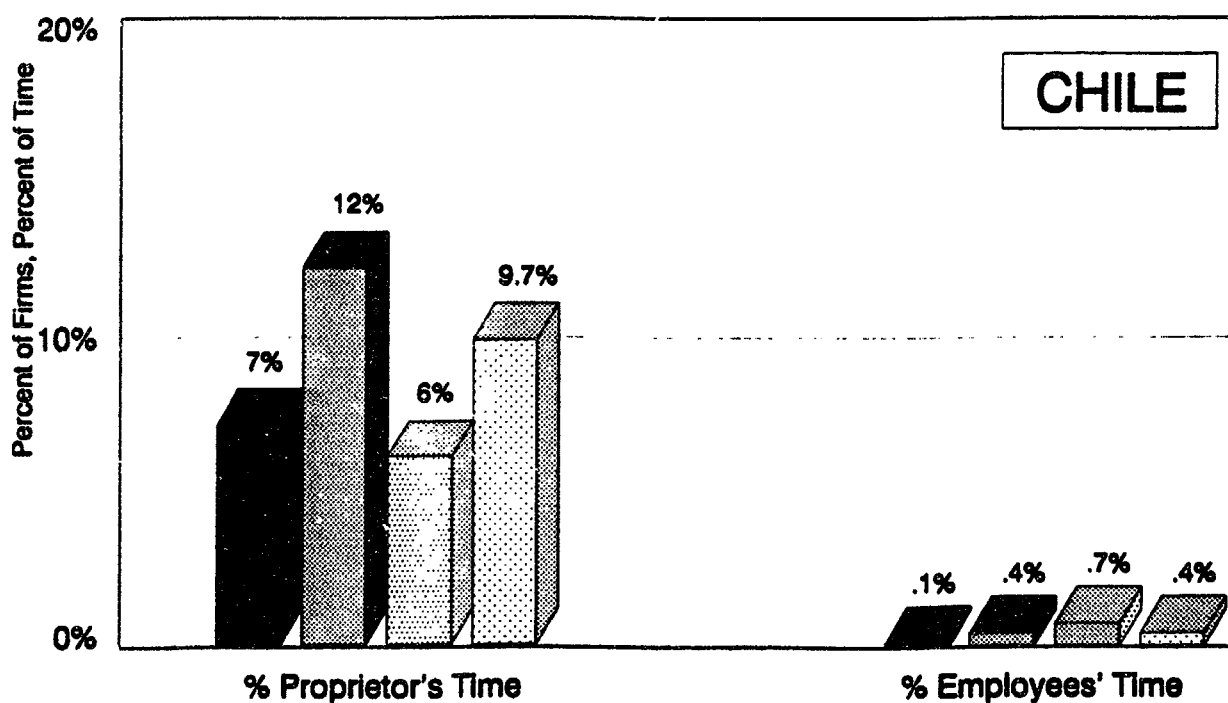
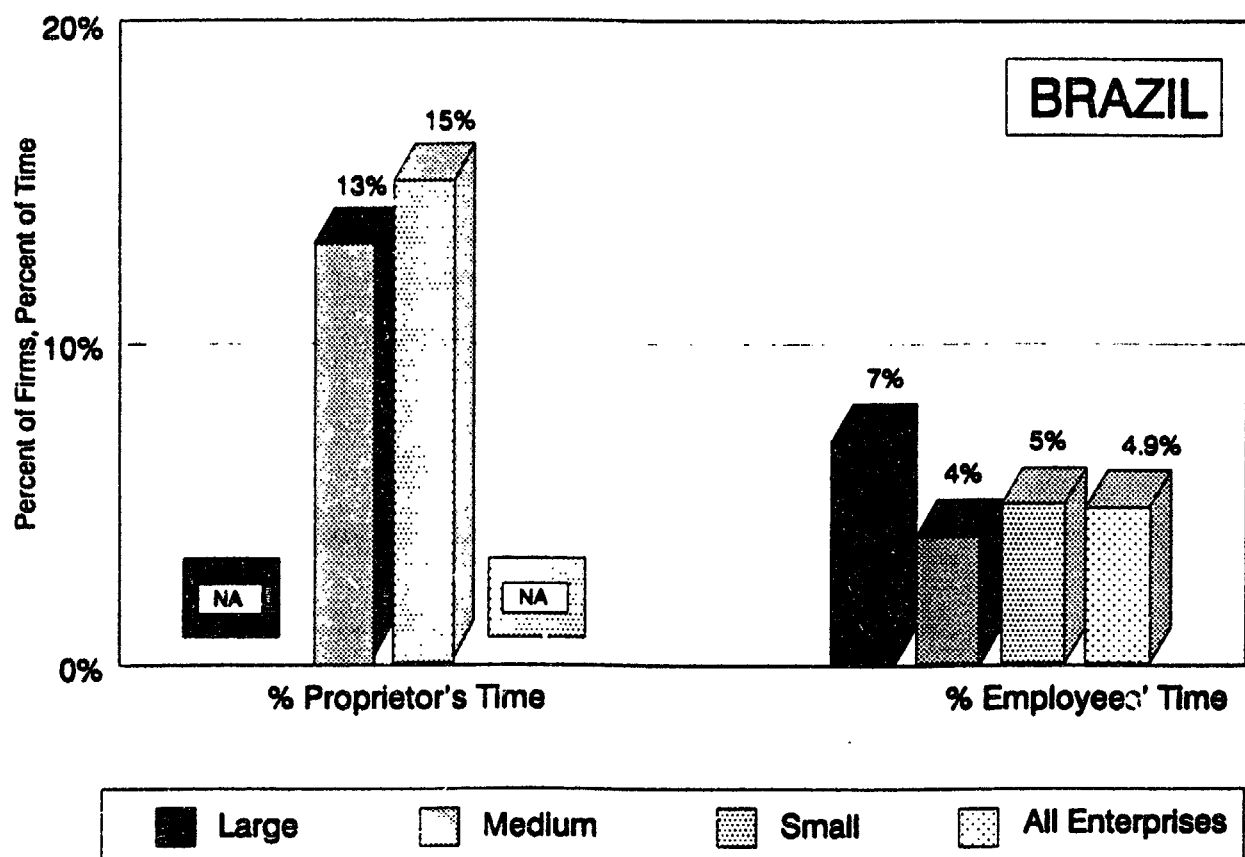
**Regulation.** Regulation and bureaucratic red tape are often identified as one of the worst products of inefficient government institutions. Excessive regulation may create a generalized drag on all businesses or may favor some kinds of businesses over others, either as an intended consequence of implementation, or as a result of the structure of costs imposed by regulation. Poor regulation not only adds to the costs of doing business, but also increases uncertainty about the returns from investments and individual transactions. Finally, if regulation imposes transaction-specific risks or costs, it may encourage companies to vertically integrate into retailing or input production as a way of avoiding market transactions.

At first glance, it would seem impossible for Brazilian firms to contend with the mass of contradictory, rapidly changing, and unknowable law that is the formal reality with which they are confronted. Brazilian garment firms identified the regulations and enforcement practices surrounding federal taxes, the state value added tax (ICMS) and labor regulations as the most vexing of their regulatory burdens.<sup>31</sup> Entrepreneurs detailed a set of over 50 federal, state and municipal taxes they must pay, some of which require monthly contributions. Thus, for taxes alone, firms must comply with over 50 sets of filing and payment requirements with inconsistent record-keeping demands. A typical sale requires the filing of four or more copies of the "nota fiscal" or sales form. Beyond this, the lack of clarity in and the changeable nature of tax and other law makes compliance difficult and opportunistic manipulation of law by rent-seeking bureaucrats relatively easy. The tax and regulatory burden is said by several entrepreneurs to double the cost of garments sold formally.

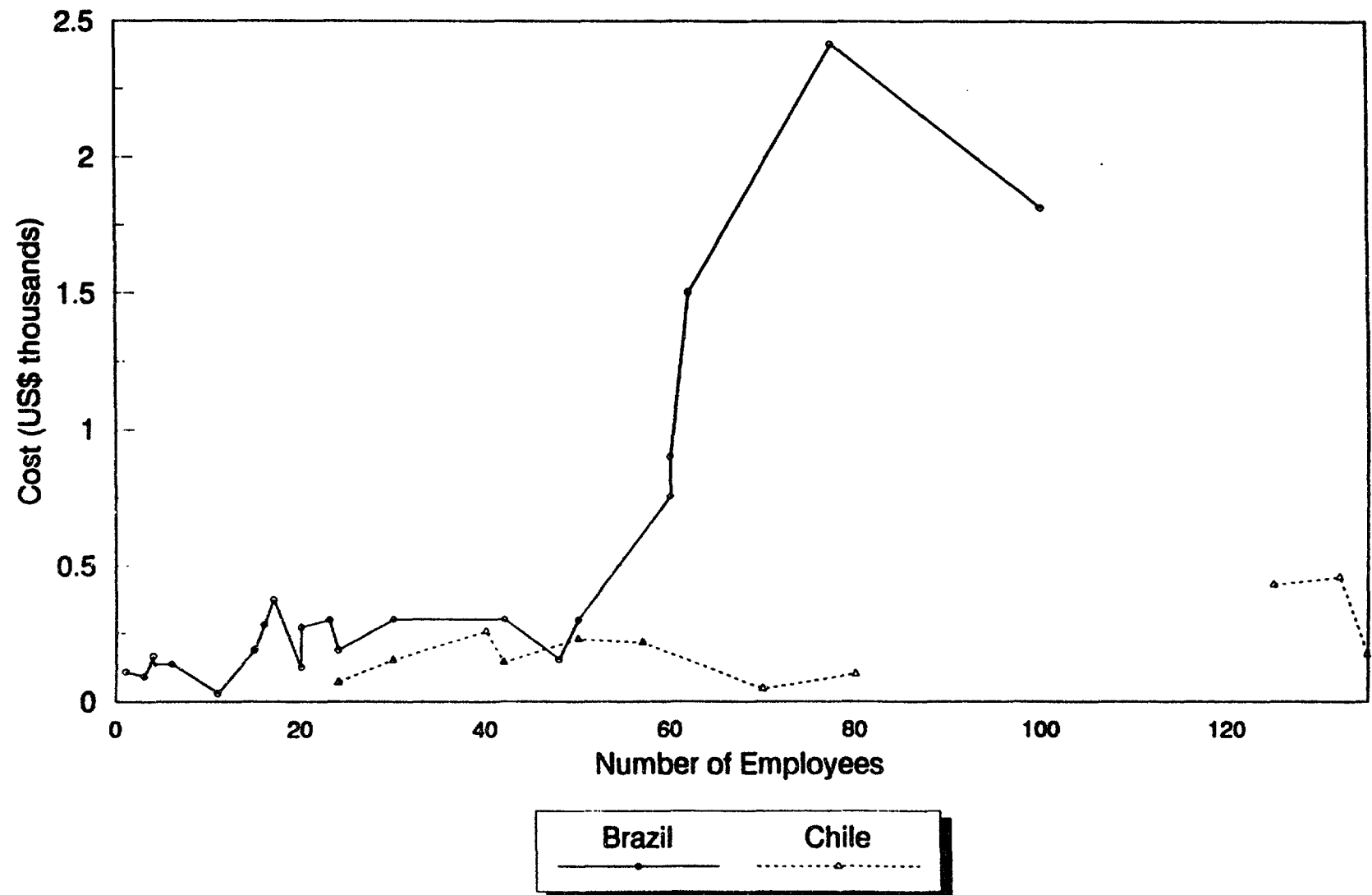
Our goal was to learn how firms contended with this complex regulatory system in practice, and at what cost. While it is hard to measure directly the costs that regulation imposes on individual transactions, we collected information (summarized in Figures 1 and 2, and Table 2) on three types of costs to firms associated with regulation: the usage and cost of external accountants; the proportion of proprietors' time spent complying with regulations; and the amount of employees time devoted to tasks of compliance. This enables us to compare costs between Brazil and Chile, to get a relative sense of the burden on business of Brazil's unreformed system, as it exists in practice.

As Table 2 summarizes, small Brazilian firms generally hire an outside accountant to handle their taxes at an average cost of \$525 per month, with a range from \$91 to over \$2000. Figure 2 shows us why

**Figure 1**  
**Recurrent Costs of Compliance with Government Regulations**



**Figure 2**  
**BRAZIL AND CHILE: Cost of Tax Preparation**  
(per month)



medium and large firms internalize these functions -- once they grow beyond 50 to 60 employees, contracting out becomes too expensive, and a full time person is needed to focus on the complex requirements of a larger firm (although some firms hire external auditors to assist in compliance with ever-changing regulations). This may be due to tougher enforcement by government officials of tax regulations (including payroll taxes) against larger firms, as well as to labor regulations that apply to larger firms. In addition, the rewards to scrutiny may be greater for officials in the case of firms with 60 or more employees.

**TABLE 2: USE AND COST OF EXTERNAL ACCOUNTANTS**

	BRAZIL				CHILE			
	SMALL	MEDIUM	LARGE	ALL	SMALL	MEDIUM	LARGE	ALL
% Using an Accountant	96%	15%	20%	61%	70%	52%	57%	57%
Monthly Cost Accountant (U.S. \$)	\$515	\$806	n.a.	n.a.	\$126	\$409	\$1313	\$400

In addition to using outside consultants, Brazilian proprietors of small and medium firms devote an average of nearly 15% of their time to regulatory compliance activities. For the largest firms, the function requires whole departments, and becomes a specialized management function, hence an accurate measure of managerial time spent was too complicated for respondents to quickly estimate. In addition to top management's time, between 4% (for medium firms) and 7% (for large firms) of employees' time (an average of 3.75 full time employees for small and medium firms) is spent on activities related to compliance with government regulations.

In sharp contrast to Brazil, the most striking feature of Chilean responses was the number of entrepreneurs who had no complaints about the government. The most frequent response to a question about the public agency that created the most difficulties was "none" (22.5% of responses, 40% for small firms). The common response was: "If you pay your taxes, there is nothing to worry about." 24% of respondents said that their proprietors or senior managers spent between zero and one percent of their time dealing with bureaucracy. 31% of respondents required the equivalent of between zero and one tenth of one full time employee to comply with government bureaucracy. While complaints were

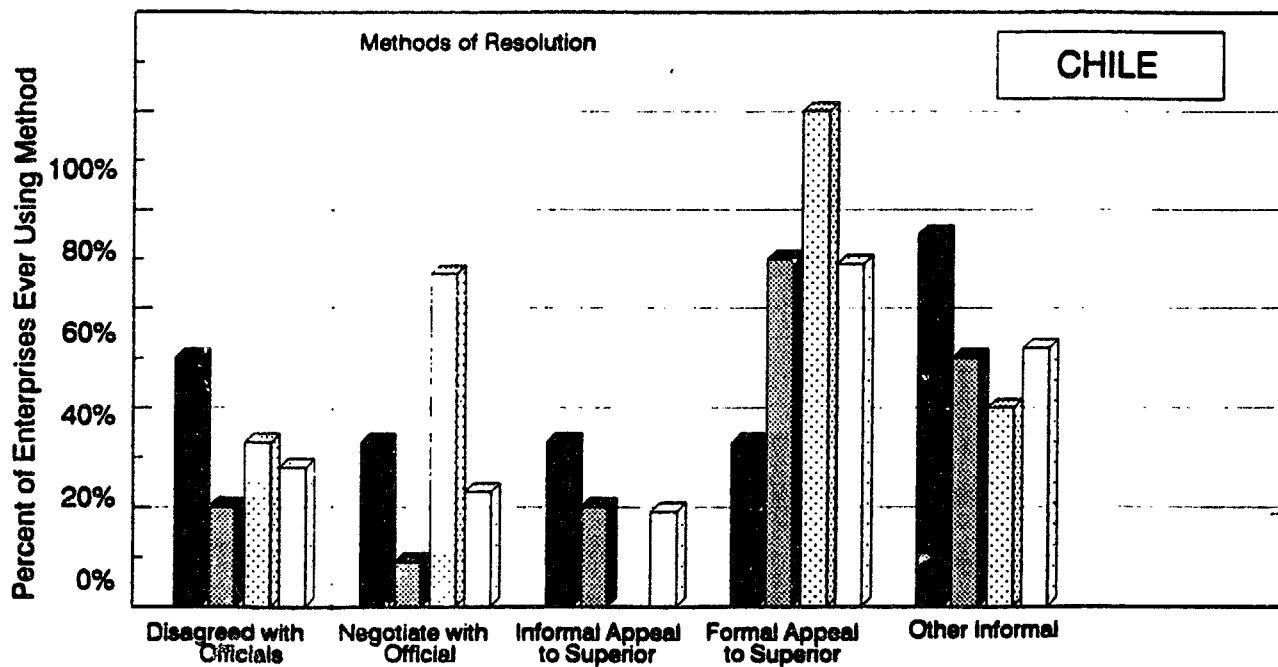
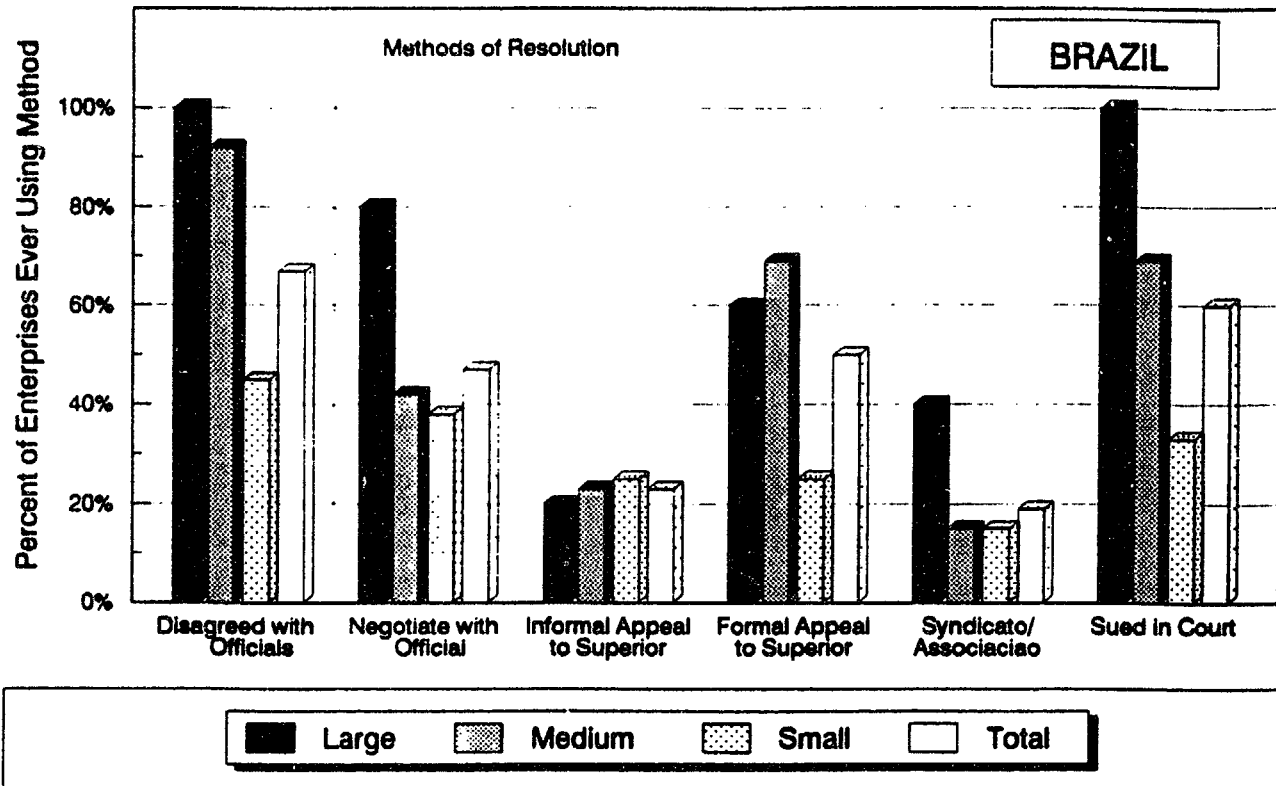


registered about the Tax Revenue service, municipal building permits and taxes, and labor regulations, responses indicated a much higher level of contentment. Turning to the specific cost measures, while the majority of Chilean firms use external accounting services, the average cost -- at \$335 per month -- is only 63% of that of their Brazilian counterparts. In particular, small firms in Chile pay an average of only \$111 a month for their accounting services, while Brazilian small firms average a payment of \$515 (\$428, omitting one outlier). This implies that the minimum fixed accounting-related cost of operation -- a necessary burden for all businesses that choose to enter as formal firms -- is lower in Chile. Additionally, there is a much weaker relationship in Chile between the use of an external accountant and the size of the firm, implying that, other things being equal, there is no size at which government-demanded records become too complex or expensive for an external agent to handle. 57% of large firms use external accountants, paying them an average of \$934 per month.

Chilean entrepreneurs spend somewhat less of their own time contending with the requirements of government bureaucracy -- 10% as compared with 15% for their Brazilian counterparts. Furthermore, whereas for Brazil the heaviest burden on proprietor's time falls on small enterprise, the regulatory burden is lightest for the smallest Chilean firms, whose proprietors spend an average of only 6% of their time contending with government, again evidencing lower barriers to entry. An even more striking difference lies in the staff time required for compliance: the average Chilean firm requires the equivalent of only two thirds of one full time employee to deal with bureaucracy and government requirements, as opposed to an average of over 3.75 full time equivalents for small and medium Brazilian firms.<sup>32</sup>

In addition to differences in the regulatory costs associated with everyday operation, Brazilian and Chilean firms also differ in the prevalence of disputes with government officials and in the way in which they are resolved. Brazil's complex regulatory environment creates a high level of conflict for medium and larger firms. There was a general feeling among businesses that agents of bureaucracy "could always find something wrong." As Figure 3a shows, two thirds of the Brazilian firms surveyed have disagreed with a government official and attempted to have a ruling changed, with the proportion highest for large firms. Further, Brazil's medium and large firms are more prone than their smaller counterparts to use formal appeals processes and lawsuits to resolve conflicts with government agencies,

**Figure 3**  
**CONFLICT RESOLUTION: BUSINESS - GOVERNMENT**  
 (% with Disagreement, Methods of Resolution)



with 70% of medium firms sampled, and 100% of large firms, resorting to formal legal appeal or lawsuit at some time. Legal action defers payment of fines and tax assessments and creates a lengthy period in which a settlement can be negotiated. Furthermore, those who had used formal appeals mechanisms and lawsuits were not discouraged by them: 81% of those who had pursued these means said they would do so again.<sup>33</sup>

In marked contrast to the Brazil response, only 28% of the firms in Santiago had taken action regarding a disagreement with a government agency. Unlike Brazil, there was no suggestion by entrepreneurs that informal payments form a systematic substitute for well-functioning regulatory and conflict resolution mechanisms.<sup>34</sup> Like Brazil, a higher proportion of small firms used informal conflict resolution mechanisms than larger firms (see Figure 3b). Unlike Brazil, small firms showed no disinclination to use formal appeals processes, compared to larger firms.<sup>35</sup> Yet there was no indication of lawsuits against the government. As in Brazil, it was large firms who were most likely to act upon a disagreement with an agency decision. Overall, Chilean firms clearly bear lower compliance costs and experience less conflict with government officials.

Cumulatively, the effect of regulation in Brazil -- but not in Chile -- is to create a threshold beyond which firms face sharply increased regulatory costs. Table 3 details the average scores of respondents as to the burden of three types of regulations relative to other constraints on their expansion, with a score of zero for the least binding constraint, and a score of one for the most binding (section 5 of the paper discusses the overall constraint results in more detail). No systematic variation by firm size is evident for Chilean firms. By contrast, the scores suggest that Brazilian firms confront a 'threshold burden':<sup>36</sup> the scores are lowest for the smallest firms, rise as firm size increases, but decline again for the largest size group. Consistent with the evidence presented earlier, a plausible explanation for this pattern is that regulatory enforcement is higher for medium firms than for their smaller counterparts.

It follows that firms may rationally limit expansion as a way of remaining below the regulatory threshold. Indeed, in the course of interviews, we commonly encountered the "multiple business card" phenomenon: rather than growing big, entrepreneurs expand into multiple small businesses, each of which can carry on substantial informal activity. Hence they must fish through their pockets to produce

the correct card for the business one is discussing. The sharp increase in regulatory obstacles to medium firms (and the modest decline for large ones) suggests that large incumbents may be somewhat protected from the appearance of new large competitors.

**TABLE 3: THE BURDEN OF REGULATORY CONSTRAINTS BY FIRM SIZE**

(Normalized Level of Difficulty on a Zero to One Scale)

	FIRM SIZE			
	Less than 25 employees	25-99 Employees	100-499 Employees	500 or more Employees
<b>A: BRAZIL</b>				
Tax Bureaucracy	0.50	0.54	0.69	0.65
Labor Regulations	0.47	0.66	0.70	0.56
Other Bureaucratic Procedures	0.28	0.38	0.53	0.40
<b>B: CHILE</b>				
Tax Bureaucracy	a/	0.28	0.28	0.28
Labor Regulations	a/	0.28	0.46	0.41
Other Bureaucratic Procedures	a/	0.43	0.31	0.33

**Note:** <sup>a/</sup> Only one firm with fewer than 25 employees was interviewed in Chile; it is included in the 25-29 employee category

The nature of informality. Taken together, the analyses of entry and regulation point to an interpretation of informality that is rather different from that propounded by Hernando De Soto. Whereas De Soto attributes informality to the high cost of becoming formal, our findings focus attention instead on the ongoing regulatory and tax-related costs of operating as a formal enterprise. Further, contrary to the picture of a choice between unregistered informality and registered formality, our analysis suggests a more complex reality.

In both Sao Paulo and Santiago, we did not find unregistered firms. Efforts to track down "informal" firms in Sao Paulo inevitably led to the discovery of a formally registered firm that conducted

a certain amount of informal -- "off the books" -- activity (although anecdotal evidence suggested that there might well be concentrated pockets of unregistered businesses elsewhere in Sao Paulo State and near Rio de Janeiro). The overall evidence from the two cities studied indicated that, for those entrepreneurs deciding to start a garment business, the costs of formal legal status do not outweigh its benefits. Hence, informality in garment manufacture is not primarily a phenomenon of unregistered firms. Rather, it is one of registered firms selling a portion of their production informally and of small labor subcontractors evading regulation.<sup>37</sup>

It is virtually the norm for Brazilian small and medium businesses to engage in a considerable amount of informal activity. This activity takes two forms. First, to evade sales-related taxes, goods are sold without *notas fiscais* (government-mandated sales slips) or with *notas* understating their true value. Second, because labor regulations at least double the wage cost of labor, create substantial liabilities with regard to each worker, and prohibit the reward of individual productivity, many firms subcontract for labor on a piece work basis and/or underreport their wage bills.

Irregularities are often discovered by government officials in the record-keeping, reporting, or labor and safety conditions in individual firms. Some violations are real, some are artifices of officials' interpretations of byzantine regulations, and some are the result of direct contradictions between laws of parallel agencies or of different levels of government.<sup>38</sup> Officials have the power to impose stiff fines, and often do. But officials commonly use the fines as a stimulus for a negotiation, in which a settlement of between 5 and 25% of the fine is paid to them directly. Like eskimos with regard to snow, Brazilians have several words for these payments, including *jeitinho*, *caixinho*, and '*cafezinho*'.<sup>39</sup> Some 90% of small firms, over 70% of medium firms and 60% of large firms acknowledged making these payments, a surprisingly high number given the obvious reluctance most people have in admitting illegal activity. Even so, the declining proportion of acknowledged *jeitinhos* among larger firms provides added evidence that for those who would operate informally, there is a substantial premium on keeping individual operations small.

In sum, manageable entry costs, unmanageable formal regulatory costs, and the ubiquitous *jeitinho* work together to induce Brazilian firms to formally register, but to operate a portion of their businesses informally. Absent regulatory discretion, the *jeitinho* would lose its role as lubricant of

business transactions. But, given the complexity of regulations, in the absence of the *jeitinho* Brazilian firms would be forced to abandon their semi-formal practices, and choose between operating as purely formal ventures or exiting. Given the quagmire of Brazil's formal regulatory environment, under those circumstances many, perhaps most, would choose to exit.

#### 4. BUSINESS-BUSINESS TRANSACTIONS

Transactions between businesses also depend on the law and its enforcement. Legal formalism might guide us to an examination of civil law affecting contracts and conflict resolution: transparent law and effective legal conflict resolution mechanisms seem essential to efficient exchange. If laws are unclear and conflict resolution mechanisms slow, expensive, unfair or unpredictable, it may be harder for businesses to deal with each other. In particular, effective legal institutions would seem to facilitate impersonal transactions: trust or personal ties are not needed if there are sure and swift means to enforce contracts.<sup>40</sup> In this ideal, firms are freed to pursue the most profitable transactions, and all competitors are treated equally. Otherwise, firms committing resources to a transaction may be subject to the opportunistic behavior of their trading partners -- such as renegotiation of the terms of the exchange or failure to pay after delivery of goods.

Yet, where perfect legal institutions do not exist, and substitutes exist, how do we evaluate the adequacy of these substitutes and the urgency of reform? To provide some initial insights, we apply the NIE approach to two types of transactions: the placing of orders, and the provision of credit, by the parties to business transactions.

Orders. Producing goods against orders requires either guarantees or trust. A producer must commit time and resources to the production of an order. The more specialized the order, the harder it would be to sell to another customer, the greater would be the loss to the supplier if the orderer cancels or renegotiates once production is complete. If the good is customized to the needs of a particular customer (imagine, for example, a thousand pink and orange polo shirts with "Rafael's Pizzeria" embroidered on the pocket) without first receiving full payment, the supplier may be left in a disadvantageous position if the order does not constitute an enforceable contract: the product has little value to any other customer. On the other hand, delays in delivery or deviations from product

specifications can hurt the retailer or customer (imagine the shop receiving heavy wool suits just in time for spring).

In both Brazil and Chile, orders for garments have no legal status. Yet the consequences are quite different. In Brazil, garment orders are not secure -- price and quantity are subject to being renegotiated until delivery has been made and signed for. Figure 4 shows that renegotiation is quite common in Sao Paulo and, in periods of economic crisis, virtually the norm. Whereas in normal economic times (although some respondents denied the premise that such times exist), customers renegotiate between six and eight percent of contracts, in times of crisis (defined by respondents as coinciding with new government economic plans), 35-45% of orders are renegotiated once the order is ready for delivery. By contrast, in Chile, only about two percent of sales are renegotiated, with no reports of recent "crises" or sudden surges in renegotiation.

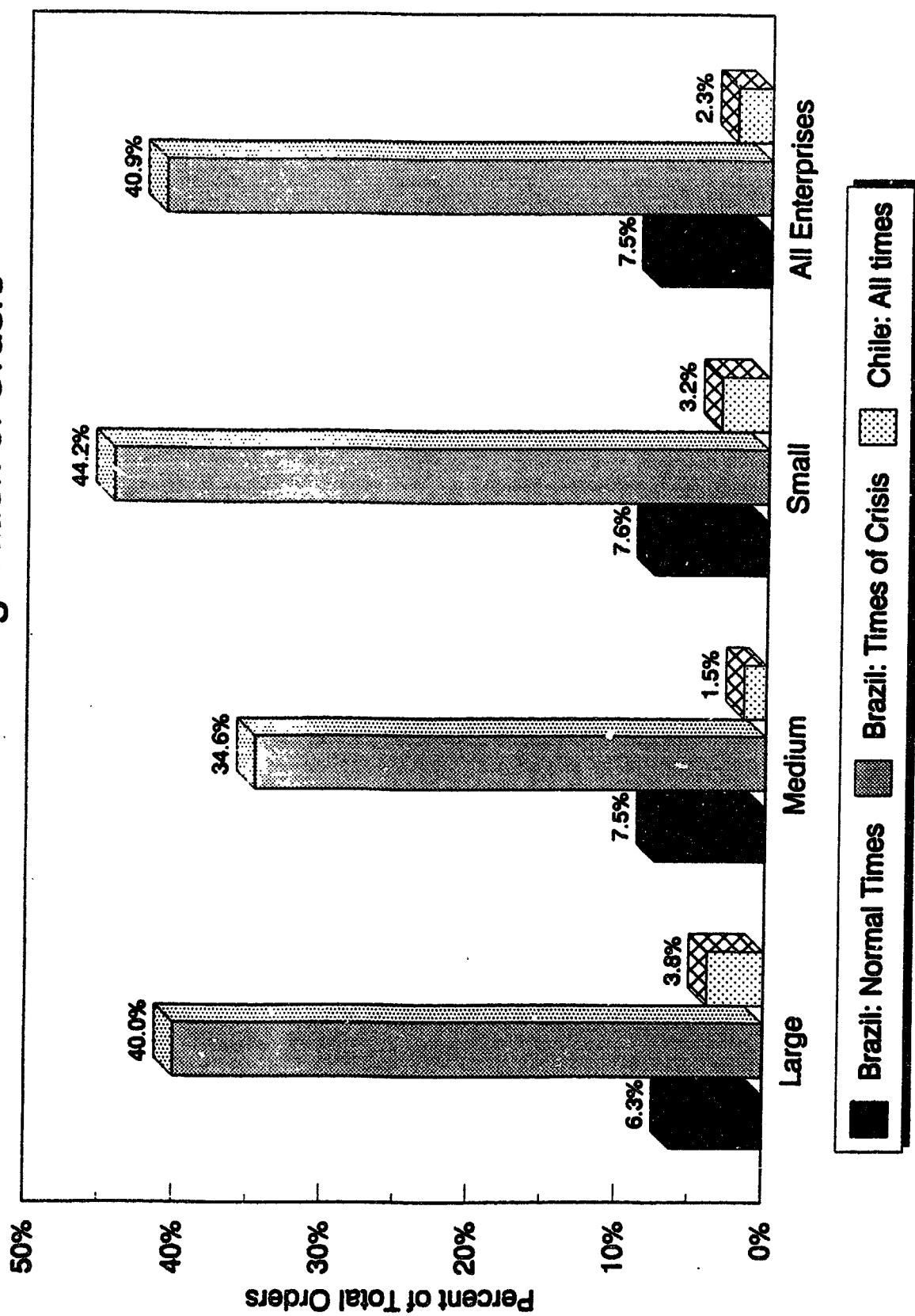
Where contracts are insecure, firms are less likely to commit large amounts of assets to a particular order. They may, instead, adopt alternative sales strategies, such as:

- \* producing non-customized items and selling from stock and/or accepting orders only for non-customized items;
- \* reducing the size of orders (or value of orders) to any one customer to diversify risk; and/or
- \* vertically integrating -- producing for their own shops to avoid the risk of sour transactions. This last option represents the substitution of a hierarchy for a market.

A look at method of sales in Brazil and Chile suggests that firms are adopting at least the first two of these strategies in response to Brazil's less reliable orders. Brazilian firms in our sample, overall, sell 42% of their goods on order from domestic customers, 44% from stock, 12% directly to retail customers, and 2% as exports. By comparison, Chilean retailers sell 50% on domestic order, 21% from stock, 24% directly to retail customers and 5% as exports. If we assume that export sales are on order and that sales to customers are from stock, then Sao Paulo's garment producers sell 46% on order as compared to Chile's 55%, a moderate difference. Clearly, trade (and other) policies of the two nations are different, and one cannot conclude a causal link between Brazil's lower reliance on orders and its institutional environment, but the pattern predicted by an inferior contracting environment is there.

Furthermore, in Brazil, many firms have adopted a strategy of accepting only small orders, to diversify risk. Brazilian firms make an average of 22% of their sales to their top three customers, while

**Figure 4**  
**Brazil and Chile: Renegotiation of Orders**





Chilean firms make 34% of their sales to their top trio. More strikingly, Brazilian firms have, on average, more customers than Chilean firms (even more surprising given that there are more small firms in the Brazilian sample): 1289 for Brazilian firms versus 242 for Chilean firms.<sup>41</sup>

The data provide no support for the proposition that Brazilian firms use vertical integration as an important response to unreliable orders. Specifically, a substantially smaller percentage of Brazilian respondents (39%) than Chilean respondents (81%) retailed any portion of their product directly to the customer. But we do have reason to suspect that the trend in Brazil is upward: about a fifth of the firms expressed an intention to establish or expand existing retail sales outlets. By contrast, in Chile, there was some indication of a decline in retailing activity among medium and large firms.<sup>42</sup>

One final indicator of a better contracting environment in Chile is the higher level of customization of inputs. Specifically, in Sao Paulo, garment firms report that 21% of the textiles they purchase are made to their specifications, while in Chile, 33% of fabrics are reportedly exclusive to their firms. For large firms in Chile, the figure rises to 45% of their inputs.

The unreliable nature of orders in Brazil is the outcome of an unstable economic environment. Clearly, the contracting mechanism used in orders is weak, but it is a weakness mutually consented to by buyer and seller and not a result of a malfunctioning court system. Lawyers informed us that it is perfectly possible to write a binding contract for an order, citing the example of orders for cars. Some garment producers candidly acknowledged that they renegotiate contracts more often than customers, due to unforeseen shifts in the price of their supplies. And older producers recalled that, before the age of extreme inflation, contracts were more secure and renegotiation uncommon. Furthermore, orders are no more legally binding in Chile than in Brazil, yet they are, by comparison, rarely renegotiated.

Figure 4 makes clear that the differences between Brazilian firms of different sizes, or even between Brazilian and Chilean firms, pale in comparison with the differences for all Brazilian firms between periods of intense government economic intervention (including freezing assets and prices) and normal times. Rapid and unstable inflation makes agreement difficult at all times, yet it is sudden shocks in prices and contract values, resulting from government economic policies and the government's direct manipulation of the value of contracts, that appear to have undermined secure contracting.<sup>43</sup> One index of government bond rates used by many firms recently ceased to be issued, suppressed by the

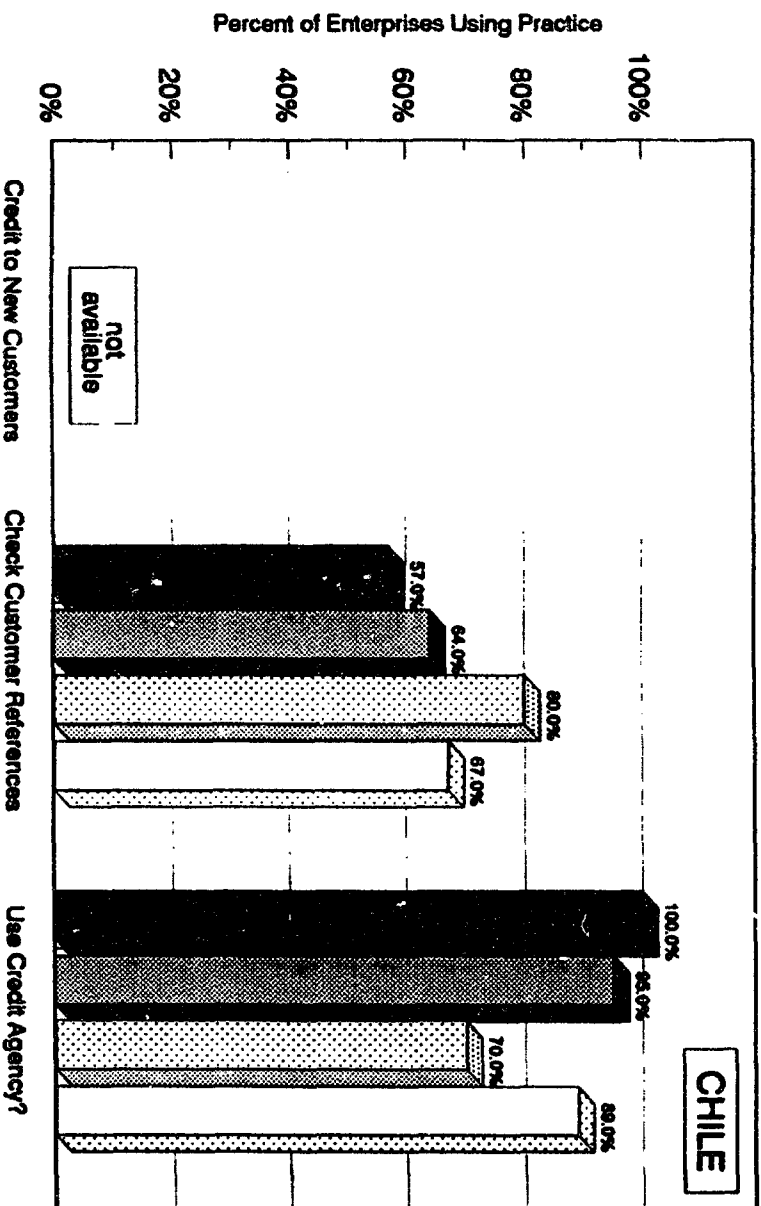
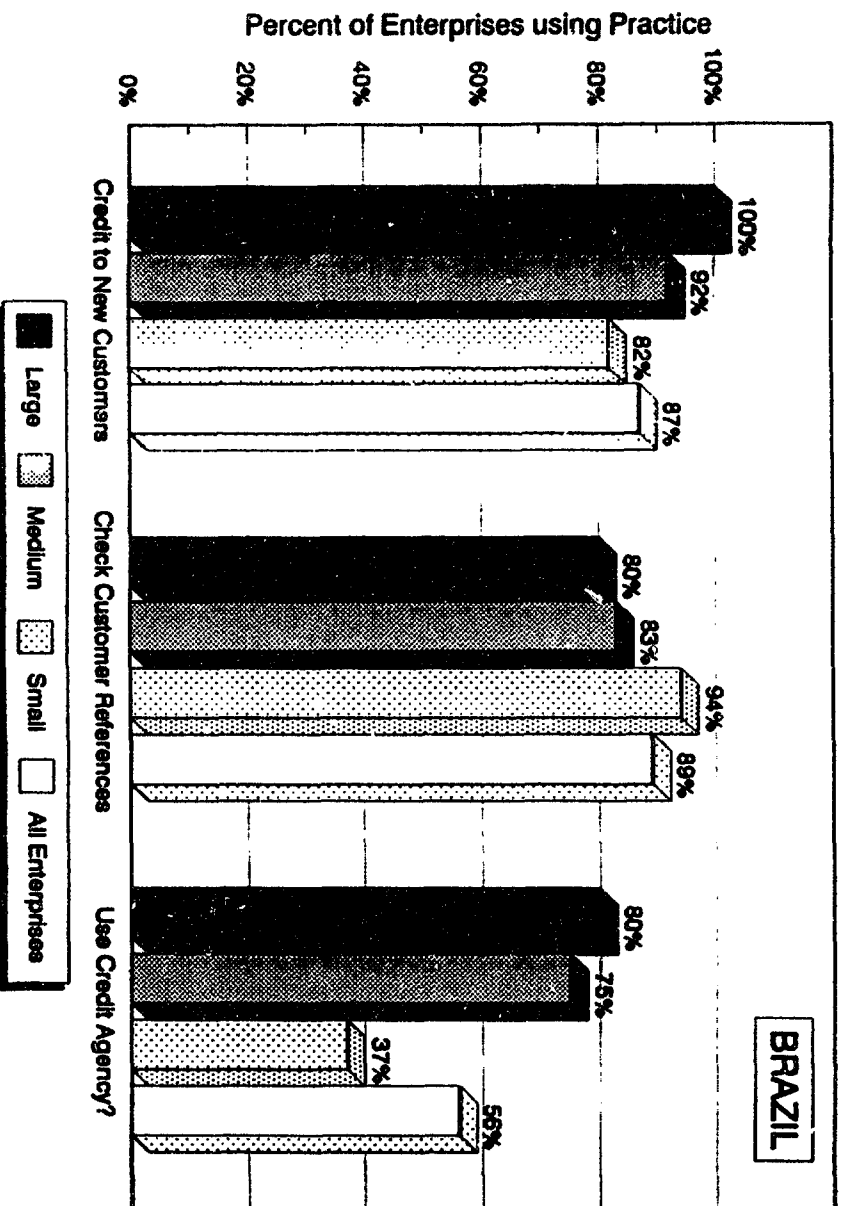
government to discourage indexation. Furthermore, the government has actively intervened to mandate re-indexation of contracted prices. Finally, the government has acted at times to freeze prices and/or assets, undermining agreements and altering values. Some manufacturers lost nearly all their orders when the government froze bank accounts, as their customers simply could not pay them. The government leaves firms with little alternative but to remain as flexible and uncommitted as possible.

Sales with Credit In both Brazil and Chile, there is a sense that the garment trade would grind to a halt without credit. Retailers cannot pay manufacturers until clothing is sold; manufacturers cannot pay textile suppliers until they are paid for their product. A formal legal perspective suggests that formal procedures should be developed to facilitate credit transactions and resolve conflicts over debt. Yet, in the garment business, transactions are small and even an efficient formal conflict resolution mechanism is likely to be costly (recall Williamson, above). Where resort to court is expensive and time consuming, do firms nonetheless extend credit?

The answer in Sao Paulo's garment sector is "yes." Transactions involving sales with credit demonstrate an important institution: an effective information system, which places a premium on an untarnished reputation, largely obviates the need for effective enforcement mechanisms in the case of default. We were, quite frankly, surprised by the readiness of firms to offer credit to new customers and the dominance of supplier credit as a source of working capital. For example, eighty-seven percent of respondents give credit to new customers. Small firms are the most likely to request cash payment on the first transaction, yet only 18% of our sample made this their practice. More generally, 85% of garment sales in Sao Paulo are made with credit -- including 77% of the sales of small firms, 94% for medium firms and 96% for large ones. As the following paragraphs detail, the ability of Brazilian firms to give credit with reasonable confidence that they will be repaid arises from an *ex ante* information system more than from *ex post* enforcement mechanisms.

Credit is extended in two major ways in Brazil: through *duplicatas* -- signed invoices acknowledging receipt of goods; and through post-dated checks. Larger businesses accept post-dated checks only from retail customers, while smaller businesses may occasionally accept them from retailers as well. The *duplicata*, the dominant mode for extending credit in this context, is a legally respected

**Figure 5**  
**BRAZIL AND CHILE: Credit and Credit Checking**



document that can be used to obtain credit from banks (although the person who brings the *duplicata* to a bank for rediscounting, not the issuer, is liable for the loan).

As Figure 5 shows, firms extending credit to new customers check on them in two major ways: through references and through credit agencies. Each has its costs -- the time to check oneself or the fee of a credit agency. Sao Paulo has one major credit agency for checks, Telecheque, and several specialized agencies providing records for other forms of commercial credit. The information is generally up to date and can be obtained nearly instantly by phone or computer terminal.

In normal times, about 8% of customers that receive credit fail to pay on time, with the proportion rising to over 27% in terms of economic crisis. Patterns of recourse for unpaid debts are similar for *duplicatas* and for post-dated cheques; here we describe those relating to the *duplicata*. If a *duplicata* is not paid on time, it can either be negotiated and settled between buyer and seller or referred to publicly sanctioned offices (*cartorios*).<sup>45</sup> About half of the cases of late payment are resolved through negotiation, while the other half go on to the cartorio. The cartorio publishes a list of both those buyers who wait to pay in this office (a common and not very serious offence) and those who fail to pay even then (a relatively serious, though non-criminal offense). Private credit agencies record and disseminate this information to subscribing firms, allowing them to examine the record of new customers. As Table 3 shows, these collection and information institutions obviate the need for frequent resort to conflict resolution over credit: about 93% of those with overdue debts pay in the cartorio (within about 10 days). A retailer with a record of unpaid debts is unlikely to be able to find suppliers, so most pay to preserve her reputation. Among those that fail to pay even the cartorio, negotiation remains the dominate mode of resolution; Table 3 confirms that only a small fraction even of these cases (one tenth of one percent of all transactions involving *duplicatas*) end up in court. Those that did involved legal proceedings from a low of four months up to three years.<sup>46</sup>

In spite of Brazil's effective alternatives to formal legal resolution of debts, Table 3 suggests that Chile's formal and informal mechanisms are superior. Fewer people pay late, and an even smaller percentage go to court. Yet the similarities are more striking than the differences. In Chile, as in Brazil, two mechanisms are used for credit: the post-dated check and the *letra* (the equivalent of the Brazilian *duplicata*). Post-dated checks, in Chile, are taken quite seriously. Whereas in Brazil, bad checks may

TABLE 4: RESOLUTION OF LATE PAYMENT OF DEBT

% of Total	BRAZIL ("normal times")	CHILE (all times)	
	Duplicatas	Checks	Letras
% Pay Late	8 %	4 %	3 %
% Pay Late and Reported	4 %	.72%	.97%
% Pd Late, Reported and Not Pay	.28%	.24%	.13%
% of Total in Lawsuit	.10%	.05%	.02%

eventually result in the loss of a person's check-writing privileges, in Chile, bad checks will land the writer in jail. Within one to three months, the writer who has not made good her bad check will end up in jail, through a quick criminal law proceeding that requires only the returned check as evidence. Thus post-dated checks are widely accepted, accounting for 39% of sales for small firms and 30% of sales overall.

*Letras*, the Chilean equivalent of the duplicata, are employed in some 40% of sales. Large firms are the most dependent on *letras* -- which pay for 59% of their sales. The penalty for unpaid *letras* is less severe than for post-dated cheques, since they are enforceable through civil, not criminal statutes. Nonetheless, an effective information system -- which (as in Brazil) combines both a reporting system on unpaid debts, and credit agencies which transmit the information to firms -- assures payment of *letras*: only 3% are paid late; and only 0.02% of transactions involving *letras* wind up in court.

In sum, the comparison of Brazil and Chile suggests that courts are only a small part of the set of institutions that facilitates the flow of short-term credit. Brazilian legal processes have the reputation of being expensive, slow and unpredictable, whereas Chile's courts are reputed to be relatively swift and consistent in their judgments. Consistent with these differences, problems associated with repayment of debt are somewhat fewer in Chile than Brazil. Yet, with 85% of garment sales made on credit, Brazil's cumbersome legal system hardly can be described as a deterrent to the provision of short-term financing among firms. For this type of financing, formal conflict resolution mechanisms do not appear to be the most relevant institutions. A full understanding requires attention to institutions that are not part of the formal legal system: the informational and reputational system that allows firms to extend credit.

## 5. OBSTACLES TO GROWTH: WHAT ARE THE BINDING CONSTRAINTS?

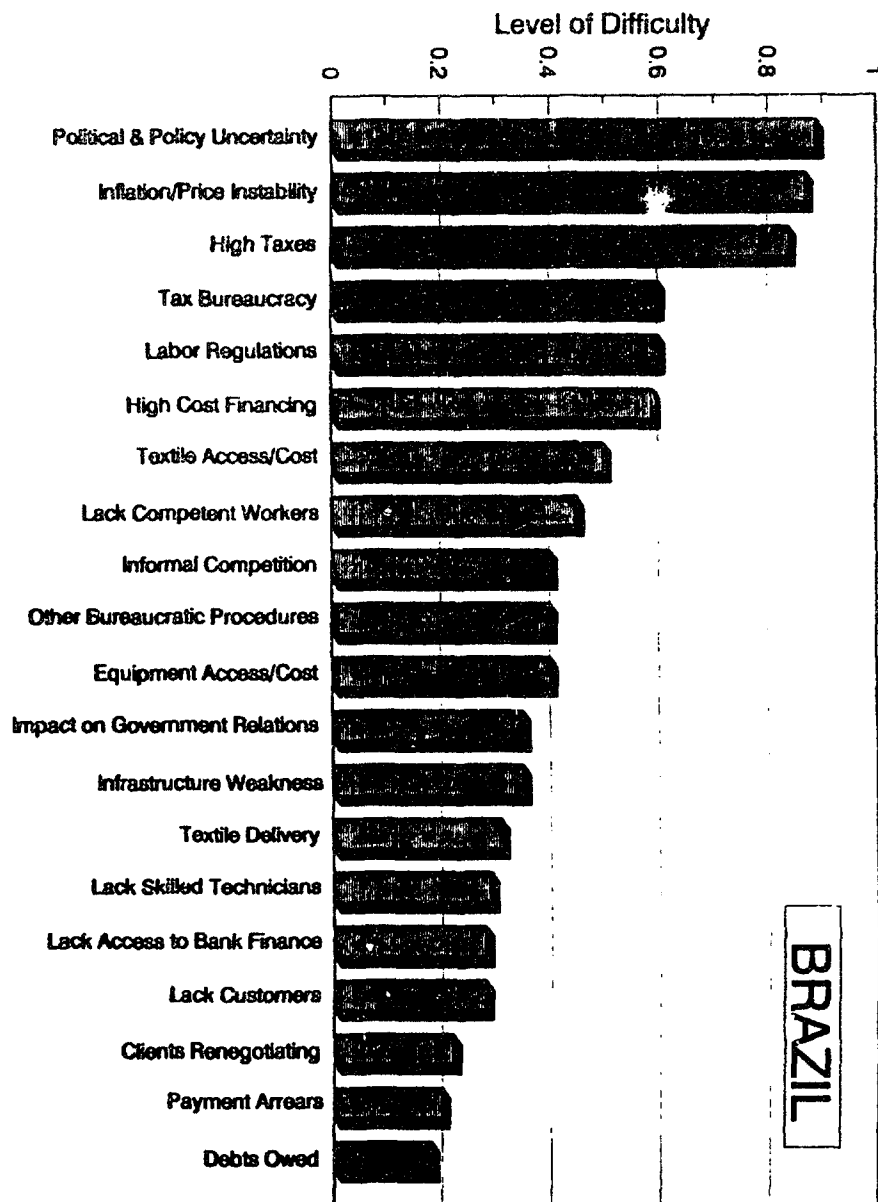
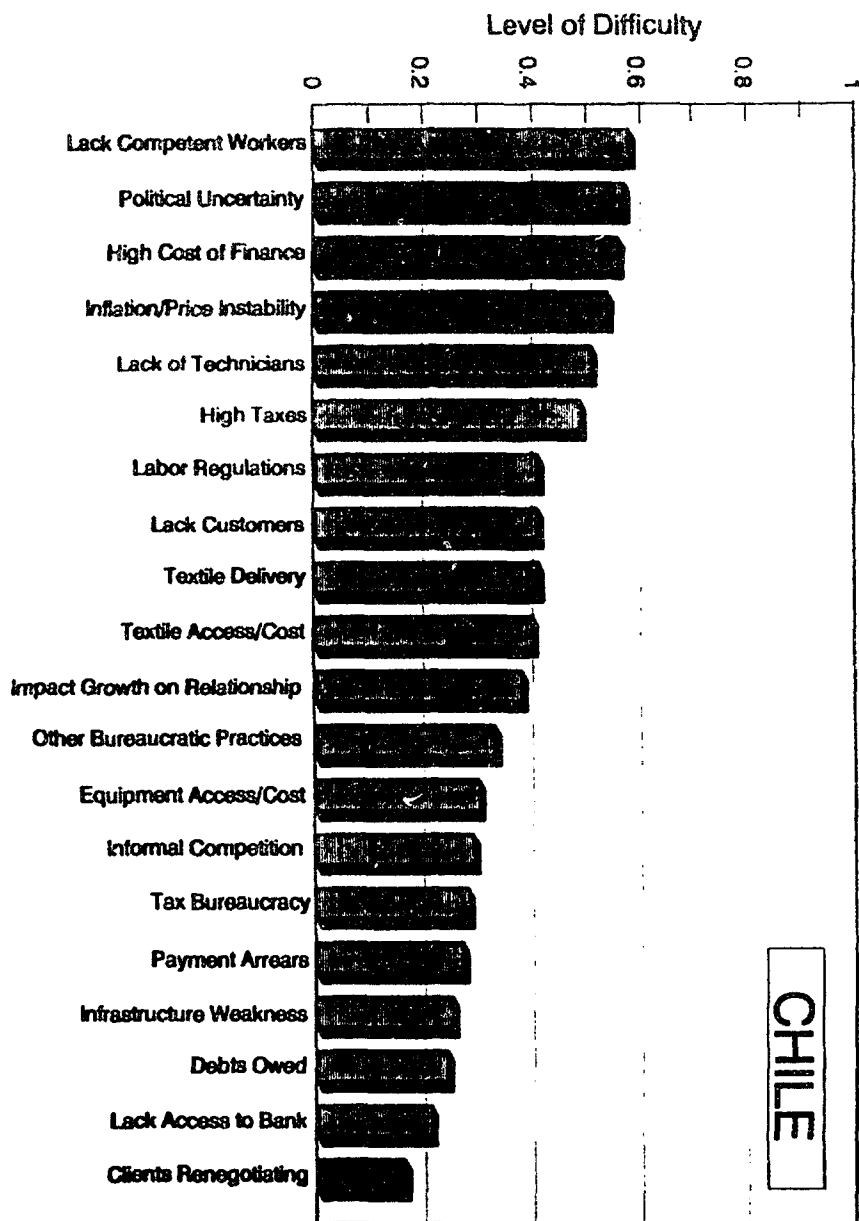
Both Brazilian and Chilean garment firms reported that they intend to grow substantially during the next two years, and it is important to their economies and to employment (given the high labor intensity of the industry) that they do so. In an economy and society like Brazil's, the agenda for economic reform is broad and far exceeds the government's capacity to address in the short term. How, then, should we rank possible legal and regulatory reforms against other reforms that may consume the time, energy and political capital of a reform-minded government? Which constraints are binding, which merely a nuisance?

Here, looking at formal law gives us little guidance. Clearly, many laws, enforcement practices and conflict resolution mechanisms can stand improvement, but what guidance does the Law and Development approach give us about where to start? An NIE approach, however, directs us to the actual experiences and priorities of businesses.<sup>47</sup>

To this end, we asked Brazilian garment entrepreneurs to rate various obstacles to growth and future operation on a 1 to 5 scale. In doing so, they revealed a clear and sobering picture of their most serious obstacles to growth, particularly sobering to those who would target legal reform. Figure 6 presents the average, normalized (on a scale of zero to one) evaluation by entrepreneurs of a list of obstacles to future operation and growth that we offered them. The obstacles they find the most serious are not those directly related to legal and regulatory institutional reform, but rather those pertaining to overall economic management. The three factors seen as the greatest obstacles to reform are policy uncertainty, price instability and inflation, and the high level of taxes. A second tier of obstacles relates to tax bureaucracy and labor regulation. Respondents placed obstacles related to the formal legal system and formal conflict resolution (e.g. renegotiated contracts, payment arrears and debts owed) at the end of a long list of complaints. Our research makes clear that reform of formal legal systems and formal conflict resolution mechanisms were not priority obstacles for garment firms.

In sharp contrast, Chilean respondents did not identify any group of obstacles with equal unanimity or fervor. Policy-related variables did not stand out -- the single greatest obstacle identified was the lack of competent workers. Political uncertainty did rank second, most likely due to the recent transition to democratic government. While rankings, like personal utilities, cannot be compared across

**Figure 6**  
**OBSTACLES TO ENTERPRISE GROWTH**  
 (normalized)



nations, it was striking that Chileans systematically chose lower average rankings than Brazilians (even after normalization, due to the high number of zero rankings). Chilean responses are more clustered, implying that no great common problem elicits a consensus response. Only Brazilian entrepreneurs, motivated by common frustration with government policy, lay out a distinct and clear sequence for reform.

## 6. POLICY IMPLICATIONS

Over the past five years or so, development analysts and practitioners have begun to turn their attention to the institutions that underpin development, and have initiated reforms of legal and regulatory institutions that are intended to strengthen the enabling environment for efficient, private sector led growth. However, the reform agenda has thus far been driven more by an *ex ante* perception that efficient institutional arrangements should resemble rational Western norms of law and jurisprudence than by empirical assessments of what in practice are the costs to private firms of institutional shortfalls. The goal of the research reported in this paper was to strengthen the empirical foundations for legal and regulatory reform. Four principal conclusions emerge.

First, the institutions and practices that provide the foundation for business transactions encompass very much more than the formal, public institutions that are usually the targets of scrutiny and reform. The comparative analysis reveals a Brazilian system considerably more difficult in practice than that of Chile, yet considerably less difficult than written law and formal procedure would imply. Brazilian firms have found surprisingly effective substitutes for the lack of efficient regulation and inexpensive formal conflict resolution -- a pattern consistent with Alexander Gerschenkron's classic proposition that developing countries invent institutional substitutes for arrangements prevailing in developed countries.<sup>48</sup> Thus Sao Paulo's multi-staged, complex formal process of entry (much like the one described for Lima by Hernando de Soto) turned out in practice to be a one stop, simple process for the average new business, one in which work of accountants and despachantes in large part substitutes for (the absence of) an efficient formal system of entry. Similarly, credit information and the need to maintain one's reputation to stay in business act as reasonable substitutes for quick and cheap formal conflict resolution mechanisms. Further, in the garment industry, firms have been able to adopt flexible



production and marketing strategies -- producing non-customized items, and diversifying risk by having many customers each with small orders -- to address the unpredictable environment for contracting. In this sense, entrepreneurial flexibility substitutes for formal mechanisms through which buyers and producers could commit themselves to firm orders at a pre-agreed price. As the comparison with Chile confirms, institutional substitutes do not fully compensate for the difficult legal and regulatory environment for business transactions. But they do allow a surprisingly vibrant and competitive industry to operate -- albeit one where a substantial fraction of transactions take place outside the formal economy.

Second, the results strongly suggest that, at least in Brazil, legal institutional reform, while ultimately important to attaining the full potential of the economy, can wait for the resolution of more urgent and binding constraints to private sector development. One clear result of our survey is that, above all, Sao Paulo's garment entrepreneurs seek a more stable political economy and lower taxes. Indeed, responses highlighted the cost of macro-instability to micro-efficiency and the security of property rights.

Third, even though institutional substitutes help smooth over the rough edges of Brazil's cumbersome formal institutions, and even though macroeconomic policy clearly emerges as the most binding constraint on enterprises, our research has nonetheless identified an urgent agenda for regulatory reform. To be sure, not all regulation weighs equally on garment firms: the burden of red tape at entry, for example, appears small, as does the burden imposed by cumbersome formal legal institutions. Rather, the two areas that appear most important to Brazilian firms are those regulations relating to taxes and labor. The laws are complex, hard to know, expensive to comply with, and sometimes arbitrarily enforced. Nor does the burden of these regulations fall equally on all firms: the evidence suggests that large incumbents, while not protected from the entry of competitors, may be modestly protected from these competitors becoming large by the substantial threshold burden imposed by tax and labor regulation as firms grow. This "insider-outsider" pattern limits the potential of new entrepreneurial talent to contribute to the development of the Brazilian economy.

Finally, the research implicitly suggests that proponents of legal reform could strengthen their case by identifying more precisely which business activities are most burdened by a weak formal legal

system. Our research suggests that Brazil's legal system and complementary institutional arrangements were adequate for spot transactions, and transactions which required short-term commitments, and those which did not involve transaction-specific investments. What is less clear -- and what we could not learn from the garment industry (where transaction-specific investments are relatively unimportant) -- is whether Brazil's institutional arrangements are adequate for firms to commit assets to production specific to another firm; any inability to commit resources to long-term inter-firm relationships could undermine the dynamism of private sector development. In Sao Paulo, the ability to commit clearly suffered from the unpredictable rate of inflation. But even with a stable macro-economy, Brazil's legal system might well turn out to be inadequate for long-term commitments. This implies a need for research of sectors where technology is more specialized.

## NOTES

1. The views expressed in this paper are those of the authors, and do not necessarily represent those of the World Bank, its Board of Executive Directors or the countries they represent. The work was carried out with the support and interest of Geoffrey Shepherd and Mary Shirley and benefited from the assistance of Roy Gilbert, Alberto Abu-Mohr, Karin Dhadamus, Thomas Magyar and Fausto Lerner. Lisette Price provided useful comments on an earlier draft.

2. This "ideal" would clearly depend on social goals for income distribution and other merit goods.

3. "The former postulate [of neoclassical theory] evolved in the context of the highly developed, efficient markets of the Western world and has served as a useful tool of analysis in such a context. But those markets are characterized by the exceptional condition of low or negligible transaction costs. I know of no way to analyze most markets in the contemporary world and through history with such a behavioral postulate." Douglass C. North Institutions, Institutional Change and Economic Performance (Cambridge: Cambridge University Press, 1990) p. 108

4. A World Bank official recently espoused this view as follows: "If the law is to be an effective vehicle for implementing policies and promoting orderly developmental changes in a society, the overall legal and institutional framework must be sound. That framework is of vital importance to all economic agents in the development process -- from the large industrial conglomerates to the small entrepreneur and farmer." Ibrahim Shihata. "Law and the Development Process" Bank's World March, 1990 p. 12

5. In fact, it was Max Weber who first connected rational European-style legal systems to capitalist industrial development: "[T]he rationalization and systematization of the law in general and ... the increasing calculability of the functioning of the legal process in particular, constituted one of the most important conditions for the existence of ... capitalistic enterprise, which cannot do without legal security." Max Weber cited in Karst and Rosenn, Law and Development in Latin America In a recent literature survey, Imani Ellis-Cheek identifies a traditional qualitative literature, wedded to Western legal norms, and a critical literature of recent years demanding quantitative, empirical documentation of the merits of legal systems, foreshadowing the approach of NIE. *The Contribution of Law to Economic Development: A Literature Survey* Private Sector Development Advisory Group, Legal Department, The World Bank; September, 1991.

6. De Soto observes the failure of Peru's byzantine formal legal and regulatory institutions: "Taken together, all these setbacks show that legal institutions have ceased to provide the means to govern society and to live in it. ... Moreover, lack of access to the protection and opportunities with legal institutions ought to provide seems to give most Peruvians the feeling that the system is unfair and that institutions discriminate among the population rather than unite it." Hernando de Soto. The Other Path: The Invisible Revolution in the Third World (New York: Harper and Row Publishers, 1989) p. 232 Although chronicling the rise of informal institutions that have substituted for formal ones, de Soto and his organization, the Institute for Liberty and Democracy [ILD] prescribe a standard, formal Law and Development solution: "The ILD's paradigm for economic growth in the Third World stresses the need for democratic institutions to achieve market-oriented development. The ILD believes that accessible institutions which adequately protect property rights, facilitate public participation in the decision-making process and set forth facilitative law to promote private enterprise, are the only way to open up economies and political systems to all citizens. This is the foundation for sustainable growth." *ILD Newsletter*, October 1990, Vol. 1, No. 2, p. 1

7. De Soto's book briefly describes a study of 50 small industries in Lima and the regulatory costs they actually face. This study does attempt to determine what different regulations cost businesses, finding that actual taxes paid form the minority of expenses imposed by government. Instead, labor is unduly burdened by regulation, biasing businesses towards capital-intensive production modes. However, it is

his more formalistic study of the steps required to open businesses that has captured the greatest attention and publicity.

8. Ronald Coase is commonly credited with fathering this school of thought: "One of the purposes of the legal system is to establish the clear delimitation of rights on the basis of which the transfer and recombination of rights can take place through the market." Ronald Coase "The Federal Communication Commission." Journal of Law and Economics. 2 (1959), pp. 1-40 cited in Oliver Williamson. "A Comparison of Alternative Approaches to Economic Organization" Journal of Institutional and Theoretical Economics 146 (1990), pp. 61-71. However, one could also attribute the attention to the legal definition of property rights Jeremy Bentham: "Property and law are born together, and die together. Before laws were made, there was no property; take away laws, and property ceases." Bentham cited in Karst and Rosenn. Law and Development in Latin America p. 695

9. Williamson (1990) *Ibid.* p. 67

10. See, for example, Oliver Williamson. *Economic Organization: Firms, Markets and Policy Control*. (Sussex: Wheatsheaf Books, 1986)

11. Describing the sale of a piece of real estate, North writes: "Institutions determine how costly it is to make the exchange. The costs consist of the resources necessary to measure both the legal and physical attributes being exchanged, the costs of policing and enforcing the agreement, and an uncertainty discount reflecting the degree of imperfection in the measurement and enforcement of the terms of the exchange. ... Institutions in the aggregate define and determine the size of the discount, and the transaction costs that the buyer and seller incur reflect the institutional framework. ... It is worth emphasizing that the uncertainties ... with regard to the security of rights are a critical distinction between the relatively efficient markets of high income countries today and economies in the past as well as those in the Third World." Douglass C. North Institutions, Institutional Change and Economic Performance (Cambridge: Cambridge University Press, 1990) pp. 62-3 In an applied context, Cheryl Gray looks at the mixture formal and informal legal processes in Indonesia in her paper *Legal Process and Economic Development: A Case Study of Indonesia* Policy, Research and External Affairs Working Paper No. 350, World Bank, 1990

12. "The Department of Agriculture gathers data on the cost of growing peanuts, but we do not yet have a Department of Transactions to give us the crucial variables we need to operationalize the new institutional economics." James D. Hess. *A Comparison of Alternative Approaches to Economic Organization -- Comment* Journal of International and Theoretical Economics 146 (1990), p. 74

13. Claudio Frischtak [1990] observes that Brazilian industrial policy often ignored cost, saddling industry with "many internationally uncompetitive areas" and introducing rigidities into the economy in the form of barriers to entry and exit, "overdiversified production structures, and high mandated domestic content levels." See *Industrial Regulatory Policy and Investment Incentives in Brazil*. (Washington: World Bank, 1990) Restricted Distribution. For an analysis of the political economy of these interventions, see Michael Barzelay. The Politicized Market Economy: Alcohol in Brazil's Energy Strategy (Berkeley: University of California Press, 1986)

14. Rosenn describes Brazil as a country "where laws and regulations are enacted upon the assumption that a substantial percentage will be disobeyed, and where 'civil servants, be they small or powerful, create their own law.'" Rosenn, 1984, p. 2

15. This was *after* the process was "streamlined" in an "energetic campaign to stimulate exports." Rosenn, 1984, p. 21

16. "In practice, the net effect of the jeito is frequently to push the government into assuming a more laissez-faire position than it is ideologically disposed to assume. ... Permitting circumvention, as the Brazilians have done, enables the government to cater to popular pressures for restraining certain kinds of useful economic activities without actually preventing such activities." Rosenn. *Ibid.*

17. "Industry and commercial activity is much less precarious when businessmen and industrialists have a sense that no matter what changes tomorrow may bring in the law, the *jeito*, be it corrupt or public serving, will insure business as usual."

18. *Ibid.* p. 43

19. Peter Evans Dependent Development: the Alliance of Multinational, State, and Local Capital in Brazil. (Princeton: Princeton University Press, 1979). For more radical analysis, see Michael Storper. Who Benefits from Industrial Decentralization? Social Power in the Labor Market, Income Distribution and Spatial Policy in Brazil (Regional Studies Vol. 18, #2, pp. 143-64) For a less ideological analysis to Brazil's political economy of these interventions, see Michael Barzelay. The Politicized Market Economy: Alcohol in Brazil's Energy Strategy (Berkeley: University of California Press, 1986) Undoubtedly, in many industries, fiscal incentives benefited incumbents and promoted concentration. Says Frishtak [1990]: "...through the incentive system, established firms obtained unit cost advantages which have helped them to consolidate their market position. Entrants, competing for increasingly scarce fiscal resources, were at a disadvantage relative to well-informed incumbents that had already demonstrated the ability to fulfill demand requirements." *Ibid.* p. iii

20. Claudio Frishtak [1990] observes that Brazilian industrial policy often ignored cost, saddling industry with "many internationally uncompetitive areas" and introducing rigidities into the economy in the form of barriers to entry and exit, "overdiversified production structures, and high mandated domestic content levels." See Industrial Regulatory Policy and Investment Incentives in Brazil. (Washington: World Bank, 1990) Restricted Distribution.

21. Examples of the reform include: a unification of and reduction in tariffs (down from an average of 105% to a level of 11%); a reduction by two thirds of the number of items with controlled prices; and a replacement of a transactions tax with a value added tax.

22. See Michael Barzelay. The Politicized Market Economy: Alcohol in Brazil's Energy Strategy (Berkeley: University of California Press, 1986)

23. M. Rojas Structural Change and Entrepreneurship Working Paper Lund University, Sweden, 1990

24. Frishtak *Ibid.* pp. 24-5 "Moderate to high barriers are found in intermediates and capital goods, and somewhat less to consumer durables. Regulatory and promotional regimes have a more marginal impact on consumer non-durable industries populated by a large number of small and medium producers: clothing and shoes, food products (with the exception of flour milling), leather products, beverages and other consumer goods." p. 25

25. A definitional difference led one firm of 500 employees in the Chile sample to be classified as "large" and one firm of 100 employees to be classified as "medium." In the Brazil firm, while there are no firms of exactly 500 employees, there is one with 100 that is classified as "sm: ll."

26. The typical interview took place in an office in the firm itself. A small coffee was inevitably offered, and the authors thank all the respondents for their hospitality.

27. One fact became clear from both the Brazil and Chile surveys: a strong association between age and size. We asked the cost of registering only of firms that had done so in the last ten years (as calculations of cost might be difficult and the regulatory environment substantially different before this). This excluded all of the large firms in the Brazil sample and many medium-sized ones.

28. Of sixteen firms that were asked and responded, eight registered for \$500 or less, with the lowest costing \$180. Of eighteen firms responding, 10 took one month or less to register.

29. The word "despechante" means dispatcher, but refers to an individual whose job is to obtain government permits and authorizations on behalf of clients. Formally, their expertise derives from their knowing the legal requirements and administrative procedures for obtaining permits. Informally, their expertise also includes knowing which government officials can be persuaded to side-step the rules in exchange for a gratuity. Despechantes are used, not only by individuals and businesses, but also by lawyers and accountants, who regard despechantes as a distasteful but necessary means of doing their dirty work while keeping their hands clean.

30. Based on firms responding. The highest value for both Brazil and Chile were omitted as conspicuous outliers.

31. Larger firms were inclined to object more to Federal tax agencies, while smaller firms concentrated on State tax authorities (ICMS). Complaints about labor regulations were common among all firms. Firms manufacturing garments under license from a foreign company complained about the difficult process of obtaining trademark from the Federal Agency INPI. Trademark infringement is generally addressed through lawyers and courts, hence trademark protection can be quite expensive.

32. The difference is more dramatic, but the data less sound, if one includes large firms, where one Brazilian firm reported using 510 staff for bureaucratic compliance requirements and another reported using a third of its 30,000 employees to this end.

33. This suggests that formal mechanisms may work reasonably well. Perhaps the high level of conflict and the high cost of regulation are more serious problems.

34. Nonetheless, *propinas* and the *coimas* were not unfamiliar concepts to Chilean entrepreneurs.

35. This data is somewhat hard to interpret, as relatively few small or large firms responded to the question at all. Of those responding who had pursued disagreements, small firms had the highest rate of using both informal contacts with an official and formal procedural conflict resolution mechanisms. Large firms were the most likely to act upon a disagreement (50% v. 20% for medium and 33% for small), however, and were more inclined to take the issue up with a government agent's superior or to pursue unspecified informal remedies.

36. Levy [1991] uses a similar framework to analyze in detail interactions among the threshold burden, and the related fiscal and bureaucratic burdens in accounting for regulatory obstacles in Sri Lanka and Tanzania. Brian Levy, *Obstacles to the Development of Indigenous Small and Medium Enterprises: An Empirical Assessment*. The World Bank, Policy, Research and External Affairs Working Paper number 588, February 1991

37. One firm we encountered subcontracted to seamstresses in their homes. By avoiding all payroll taxes, benefits and labor regulations, the firm paid the seamstress, on a piecework basis, double the prevailing wage, and obtained twice the productivity of its factory workers, saving substantially. One of the seamstresses we interviewed acknowledged that she had none of the health insurance or pension benefits workers are supposed to receive, but questioned the value of these programs to workers as administered by the government.

38. One (perhaps apocryphal) story related by an entrepreneur illustrates well the lack of consistency among laws and the opportunities it creates for government agents: State and municipal safety codes specify different heights at which fire extinguisher must be mounted. One entrepreneur addressed this problem by having two sets of brackets for each extinguisher. When a state inspector came, the extinguisher would immediately be moved to the appropriate level. The state and municipal inspectors, undaunted by the entrepreneur's ingenuity, conspired to arrive together -- so that one was sure to find a violation and elicit a payment.

39. meaning "little fix," "collection box", and "small coffee", respectively. A blunter word, *propina*, means a tip or bribe.

40. It is quite another issue as to whether any country has such effective and affordable legal institutions that reputaxion does not play a substantial role in decisions about partners in business transactions.

41. This data would appear to contradict the "insider-outsider" hypothesis advanced on page 7.

42. Specifically, when asked to compare their current methods of selling their products to their methods before, medium firms said that 25% of their sales had been made through own retail before while 22% was currently being sold this way. Large firms reported a decline from 33 to 29%.

43. Government inflation control mechanisms have included mandating the re-indexation of contracts to conform to government prescribed inflation adjustment and the freezing of bank accounts. The first type of policy creates uncertainty about the return to assets, the second threatens rights to assets themselves.

44. There are relatively few countries where this is not the case.

45. *Cartorios* are of two major types: judicial (courts) and extra-judicial (essentially notaries). The extrajudicial cartorios are publicly granted private, highly profitable businesses, oligopolized by a few families for many generations. There are five types of extra-judicial cartorios. In this study, the relevant cartorio is the *tabelionatos de protesto de titulos*, where bad debts and bad checks can be "protested".

46. Our information on court cases is incomplete and some cases may have been pending for longer than three years. As with other formal legal procedures, large firms are more likely to sue for a bad debt (100% have done so), with medium firms less likely and small firms the least likely (only 27% have ever sued).

47. Levy (*Ibid.*) discusses in detail the methodology used here.

48. In examining the prerequisites of "modern industrialization," Gerschenkron notes the "great elasticity and variability in the industrialization processes that are known from historical experience." He finds that "it is useful indeed to think of industrial development in terms of graduated patterns of substitution for missing prerequisites." Alexander Gerschenkron. Economic Backwardness in Historical Perspective: A Book of Essays (Cambridge, Mass.: The Belknap Press of Harvard University Press, 1962) Hirschman echoes this point in describing his principal of the "hiding hands", suggesting that a "prerequisite" may "come into existence *after* the event to which it is supposed to be the prerequisite." Albert O. Hirschman. Development Projects Observed (Washington: The Brookings Institution, 1967)

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